1997 ANNUAL REPORT

MASTER DOWNHOLE CANADA INC.

ASE: MDH.A

CORPORATE PROFILE

Master Downhole Canada Inc. was incorporated by way of Articles of Incorporation as 614281 Alberta Ltd. on June 9, 1994 under the laws of the province of Alberta. On August 25, 1994, the Company amended its Articles of Incorporation to change its name to Master Downhole Canada Inc. In November 1996, the Company closed an Initial Public Offering and on December 9, 1996 the Company began trading on the Alberta Stock Exchange under the symbol MDH.A.

On February 1, 1996, the Company purchased all of the operating assets of Mason Tools, LPM Machines and Canada Coating from 560050 Alberta Ltd. The Company also acquired the right to use the name Mason Tools.

The Company is engaged in the manufacture, sale, and rental of down hole drilling tools for the oil and gas industry. The rental business is carried on in Alberta by the Mason Tools division. The manufacturing business is carried out under the name LPM Machines division. The Canada Coating division is engaged in the application of high energy plasma spray coatings which increases the resistance of various materials to wear, heat, oxidation and corrosion.

ANNUAL MEETING

The Annual Meeting of the Shareholders of Master Downhole Tools Inc. will take place in the Riverview Room of the International Hotel, 220 - 4th Avenue S.W., Calgary, Alberta, on Friday November 14, 1997 at 10:00 am. Shareholders are encouraged to attend.

HIGHLIGHTS

- Closed an Initial Public Offering on November 28, 1996.
- Listed on Alberta Stock Exchange on December 9, 1996.
- Became Wenzel Downhole Tools Inc.'s sole supplier of manufactured oil tools.
- Subsequent to year end, signed a letter agreement to acquire the technology of Wenzel Downhole Tools Inc.

	1997	1996
Revenue	$ 6,116,971	$ 907,396
Gross Margin	$ 3,255,034	$ 324,496
Net Earnings	$ 1,577,090	$ (17,622)
Earnings Per Share	$ 0.09	$ 0.00
Cash Flow Per Share	$ 0.13	$ 0.02
Current Assets	$ 2,317,064	$ 1,002,405
Current Liabilities	$ 1,402,206	$ 1,101,994
Current Ratio	1.65 to 1	.90 to 1
Plant and Equipment	$ 8,014,764	$ 4,459,541
Total Assets	$ 10,343,828	$ 5,631,316
Shareholders' Equity	$ 6,597,651	$ 3,210,347
Rate of Return on Assets	.21	.00
Rate of Return on Common Share Equity	.38	.00
Long Term Debt to Equity	.26 to 1	.29 to 1
Debt to Equity	.36 to 1	.42 to 1
Times Interest Earned	15 to 1	.70 to 1

Report to Shareholders

Master Downhole Canada Inc. had a very successful year ended May 31, 1997. At the start of the year the Company had acquired the operating assets of Mason Tools in Edmonton. Our primary objective was to become a publicly traded company. We achieved that goal and began trading under the symbol MDH.A on the Alberta Stock Exchange on December 9, 1996. Our second objective was to become more efficient in our operations and to show a substantial increase in earnings. Management had budgeted for an earnings per share of $0.05 for the year ended May 31, 1997. We are pleased to report that our actual earnings per share for that period were $0.09. This can be attributed to a strong rental market and a substantial increase in manufacturing revenues. The increased manufacturing revenues are due to the Company's relationship with Wenzel Downhole Tools Inc. The Company became Wenzel's sole supplier of drilling motors.

Our third objective was to acquire the technology of Wenzel Downhole Tools Inc. In February 1997, the Company reached a preliminary agreement with Wenzel Downhole Tools Inc. In July 1997 a letter agreement was signed and the acquisition was announced subject to regulatory and shareholder approvals. The acquisition will be considered at the Company's annual meeting. Management believes that the long term growth potential to the Company from this acquisition will be good for the Company because it gives the Company access to world markets we did not previously enjoy.

On February 1, 1997, the Company hired Mr. Rhys Jarvis to manage the motor division. Mr Jarvis is well qualified to perform this function. He has worked in the drilling industry since 1964, beginning as a driller on the rigs and progressing through many positions and levels of responsibility. He has worked in most areas of the world where drilling technology is used. The areas he has worked include Canada, the Middle East, the North Sea, Greece, Malaysia, Indonesia, the Far East, and South America. Most recently, he established two companies in Venezuela as subsidiaries of a Canadian company. He managed those companies for three years until he decided

to return to Canada. He has been involved in running, designing, repairing and selling oil field tools (including drilling motors) for over 25 years. Mr Jarvis will be a valuable addition to the management team.

Management believes that the Company will continue to grow at a rapid rate due to three factors. The first is a strong local drilling market that needs the technology to be acquired. Secondly, our manufacturing facility is extremely busy and we do not see a change in the near future. Last, the Company is researching new uses of our Canada Coating products. This could lead to a diversification of the Company's operation with very little risk and/or capital investment.

On Behalf of the Board

Bill Wenzel	Donald L Barber
William Wenzel	Donald Barber
President and	Secretary Treasurer and
Chief Executive Officer	Chief Financial Officer

Management's Discussion and Analysis

Revenue

Revenues for the year ended May 31, 1997 increased by 574% from $ 907,396 to $ 6,116,971. This increase was a result of a strong rental local market, operating the Mason Assets for a full year as compared to four months and a greatly increased level of manufacturing activity in the LPM Machines division.

Direct Costs and Gross Profit

Direct costs in the year ended May 31, 1997 were 46% of revenue compared to the 1996 ratio of 64%. This reduction in the percentage of direct costs to revenue produced a gross margin that increased from 36% in 1996 to 54% in 1997. The increased gross margin is related to the gross profit on manufactured products and operating efficiencies resulting from staff changes.

General and Administrative Expenses

These expenses increased from $ 242,755 in 1996 to $ 870,990 in 1997, but as a percentage of revenue the general and administration expenses were reduced in 1997 to 14% of revenue from 27% of revenue. The actual dollar increase is a result of increased operations. The percentage decline is due to management's intent to keep these costs as low as possible without slowing the Company's rate of growth.

Interest Expense

Interest on long term debt in 1997 was $ 171,073. This amount is high compared to the level of debt. The reason is that when the Company purchased the Mason Assets, we assumed a substantial amount of debt at an interest rate of 10% per annum. The Company refinanced that debt with the Bank of Montreal at the bank's prime lending rate plus 1.5%. This represents a significant reduction in interest costs per dollar of long term debt.

Working Capital

The net working capital increased from minus $ 99,589 at May 31, 1996 to a positive $ 914,858 at May 31, 1997.

Fixed Assets

Fixed assets, net of depreciation, increased during the period from $ 4,459,541 at May 31, 1996 to $ 8,014,764 at May 31, 1997. The increase included a substantial investment in oilfield tools and a significant increase in the capacity of LPM Machines.

Long Term Debt

Long term debt increased from $ 1,708,527 at May 31, 1996 to $ 2,285,712 at May 31, 1997. The effect on total interest expense should be negligible due to the reduced interest rate referred to above.

Debt to Equity

The debt to equity ratio was .42 to 1 at May 31,1996. The same ratio was .36 to 1 at May 31, 1997. Therefore the Company has a solid equity base from a banking perspective.

Share Capital

Share Capital increased from $ 3,228,722 (13,642,606 shares) at May 31, 1996 to $ 5,038,936 (20,549,273 shares) at May 31, 1997.

Donald L Barber

Donald Barber
Secretary Treasurer and
Chief Financial Officer

Management's Report

The accompanying consolidated financial statements and all information in the annual report are the responsibility of management. The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles. In the opinion of management, the financial statements have been prepared within acceptable limits of materiality and, when necessary, management has made informed judgments and estimates in accounting for transactions which were not complete at the balance sheet date. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances as indicated in the notes to the consolidated financial statements. Financial information contained elsewhere in the annual report has been prepared and reviewed by management to ensure it is consistent with the consolidated financial statements.

Management maintains appropriate systems of internal control. Policies and procedures are designed to give reasonable assurance that transactions are appropriately authorized, assets are protected and financial records are properly maintained to provide reasonable assurance that financial information is relevant and reliable.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements, principally through its Audit Committee.

The Audit Committee is appointed by the Board, and is comprised of directors, the majority of which are not employees of the Company. The Committee meets regularly with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is discharging its responsibilities and to review the financial statements and the external auditor's report.

Doane Raymond, an independent firm of Chartered Accountants, has been engaged, as approved by a vote of shareholders at the Company's most recent annual general meeting, to audit the consolidated financial statements in accordance with generally accepted auditing standards and provide an independent professional opinion.

Bill Wenzel

William Wenzel
President and
Chief Executive Officer

Donald L Barber

Donald Barber
Secretary Treasurer and
Chief Financial Officer

Auditors' Report

To the Shareholders of
Master Downhole Canada Inc.

We have audited the balance sheets of Master Downhole Canada Inc. as at May 31, 1997 and 1996 and the statements of earnings and retained earnings and changes in financial position for each of the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 1997 and 1996 and the results of its operations and changes in its financial position for each of the years then ended in accordance with generally accepted accounting principles.

Doane Raymond.

Calgary, Alberta

September 16, 1997 Chartered Accountants

Consolidated Statements of Earnings and Retained Earnings

For the year ended May 31,	1997	1996
Revenue	$ 6,116,971	$ 907,396
Direct costs	2,861,937	582,900
Gross profit	3,255,034	324,496
Expenses		
Advertising	47,485	15,980
Bank charges	9,196	2,048
Insurance	20,753	6,539
Interest on long-term debt	171,073	59,693
Office	109,930	26,117
Professional fees	38,804	1,727
Rent	135,281	47,081
Telephone	32,328	7,635
Utilities	57,624	18,536
Wages and benefits	222,628	36,686
Workers' compensation	25,888	20,713
	870,990	242,755
Net earnings before undernoted	2,384,044	81,741
Other revenue and expense		
Interest and other income	158,887	4,708
Depreciation	(384,568)	(104,071)
	(225,681)	(99,365)
Net earnings (loss) before income taxes	2,158,363	(17,622)
Provision for income taxes (Note 7)		
Current	56,628	–
Deferred	741,738	–
Recovery through application of loss carry-forward	(217,093)	–
	581,273	–
Net earnings (loss)	$ 1,577,090	$ (17,622)
Basic and fully diluted earnings (loss) per share (Note 2d)	$ 0.09	$ (0.00)
Deficit, beginning of year	$ (18,375)	$ (753)
Net earnings (loss)	1,577,090	(17,622)
Retained earnings (deficit), end of year	$ 1,558,715	$ (18,375)

See accompanying notes to the financial statements.

Consolidated Balance Sheet

May 31		1997		1996
ASSETS				
Current				
Accounts receivable	$	**1,349,077**	$	440,101
Inventory		**949,924**		544,220
Prepaid expenses		**18,063**		18,084
		2,317,064		1,002,405
Investment, at cost		**12,000**		12,000
Notes receivable		–		130,369
Plant and equipment (Note 3)		**8,014,764**		4,459,541
Other assets		–		27,001
	$	**10,343,828**	$	5,631,316
LIABILITIES				
Current				
Bank indebtedness (Note 4)	$	**324,389**	$	233,998
Accounts payable and accrued liabilities		**641,685**		421,804
Income taxes payable		**93,268**		36,640
Current portion of long-term debt		**342,864**		409,552
		1,402,206		1,101,994
Long-term debt (Note 5)		**1,942,848**		1,298,975
Note payable		–		20,000
Deferred income taxes payable		**401,123**		–
		3,746,177		2,420,969
SHAREHOLDERS' EQUITY				
Capital stock				
Authorized				
Unlimited number of Class A, B, C, D and E shares without par value Issued (Note 6)		**5,038,936**		3,228,722
Retained earnings (deficit)		**1,558,715**		(18,375)
		6,597,651		3,210,347
Commitments (Note 8)	$	**10,343,828**	$	5,631,316

On behalf of the Board

Director

Donald L Barber

Director

See accompanying notes to the financial statements.

Consolidated Statement of Changes in Financial Position

For the year ended May 31,	1997	1996
Cash derived from (applied to)		
OPERATING		
Net earnings (loss)	$ 1,577,090	$ (17,622)
Depreciation	384,568	104,071
Deferred income taxes	524,645	-
Gain on sale of fixed assets	(5,099)	(4,708)
Change in non-cash operating working capital	(1,038,150)	(543,961)
	1,443,054	(462,220)
Financing		
Assumption of long-term debt	–	1,905,853
Issue of capital stock net of issue costs	1,686,692	3,108,722
Note payable advances	–	40,000
Repayment of note payable	(20,000)	(20,000)
Proceeds from long-term debt	2,400,000	–
Repayment of long-term debt	(1,822,815)	(197,326)
	2,243,877	4,837,249
Investing		
Purchase of property and equipment	(4,119,321)	(4,858,904)
Proceeds on disposition of property and equipment	184,629	300,000
Notes receivable repayment (advances)	130,369	(11,869)
Other assets	27,001	(27,001)
Acquisition of investment	–	(12,000)
	(3,777,322)	(4,609,774)
Decrease in cash	(90,391)	(234,745)
Bank indebtedness, Beginning of year	(233,998)	747
End of year	$ (324,389)	$ (233,998)

See accompanying notes to the financial statements.

Notes to the Consolidated Financial Statements

May 31, 1997

1. OPERATIONS

The Company was incorporated on June 9, 1994 as 614281 Alberta Inc. On August 25, 1994 the Company changed its name to Master Downhole Canada Inc. Operations began in November, 1994.

Effective February 1, 1996, the Company acquired the operating assets of 560050 Alberta Ltd. The statement of operations reflects the operations from these assets since the acquisition in February, 1996.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) Inventories

Inventories are comprised of raw materials and finished goods. Raw materials are valued at the lower of cost, determined on a first-in, first-out basis, and replacement cost. Inventories are valued at the lower of cost and net realizable value.

b) Plant and equipment

Plant and equipment are recorded at cost. Depreciation is calculated at the following rates and bases designed to write-off the cost of the assets over their estimated useful lives:

Automotive equipment	30% declining balance
Office equipment	20% declining balance
Computer hardware	30% declining balance
Oilfield tools	15 years, straight-line
Machinery and shop equipment	15-20 years, straight-line

c) Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Maxi Tech Machines Ltd. All intercompany transactions have been eliminated on consolidation.

d) Earnings per share

Basic and fully diluted earnings per share is computed on the weighted average number of shares outstanding of 17,671,495 (1996 - 5,055,241) and 18,560,385 (1996 - 5,171,241) respectively.

e) Financial instruments

Financial instruments are initially recorded at historical cost. If subsequent circumstances indicate that a decline in the fair value of a financial asset is other than temporary, the financial asset is written down to its fair value. Unless otherwise indicated, the fair values of financial instruments approximate their recorded amounts.

The fair values of cash, accounts receivable and current liabilities approximate recorded amounts because of the short period to receipt or payment of cash. The fair value of the Company's long-term debt is estimated based on quoted market prices for the same or similar issues or on the current rates offered to the Company for debt of the same duration to maturity. The fair values of other financial instruments held by the Company are estimated primarily by discounting future cash flows using current rates for similar financial instruments under similar credit risk and maturity conditions.

3. PROPERTY AND EQUIPMENT

	Cost	Accumulated Depreciation	1997 Net Book Value	1996 Net Book Value
Automotive equipment	$ 109,653	$ 40,572	$ 69,081	$ 125,628
Office equipment	26,910	7,107	19,803	24,733
Computer equipment	16,517	4,678	11,839	9,000
Oilfield tools	5,667,658	309,640	5,358,018	2,521,298
Machinery and shop equipment	2,679,672	123,649	2,556,023	1,778,882
	$ 8,500,410	$ 485,646	$ 8,014,764	4,459,541

4. BANK INDEBTEDNESS

The Company has arranged a line of credit with a chartered bank to a maximum of $500,000.

The bank indebtedness bears interest at bank prime plus 1.5% and is secured by accounts receivable and a second charge on fixed assets.

5. LONG-TERM DEBT

	1997	1996
Non-revolving demand term loan, bearing interest at Bank of Montreal prime rate plus 1.5%, due January 2004, repayable in monthly installments of $28,572 plus interest. As security the lender has a first charge on all assets of the Company, accounts receivable and inventory	$ 2,285,712	$ –
Due to Mason Tools Ltd.	–	1,708,527
	2,285,712	1,708,527
Less current portion included in current liabilities	342,864	409,552
	$ 1,942,848	$ 1,298,975

Principal repayments for the next five years are summarized as follows:

1998	$ 342,864
1999	$ 342,864
2000	$ 342,864
2001	$ 342,864
2002	$ 342,864

6. CAPITAL STOCK

a) Issued:

	Number of Shares		Amount
Balance, May 31, 1995	1,400,000	$	120,000
Issued on acquisition of shares of Maxi Tech Machines Ltd.	333,333		63,360
Issued on purchase of property and equipment	9,272,173		2,781,652
Issued for cash	2,637,100		263,710
Balance, May 31, 1996	13,642,606		3,228,722
Issued by prospectus, net of issue costs of $337,308 and deferred income tax recovery of $123,522	6,666,667		1,786,214
Issued for cash	240,000		24,000
Balance, May 31, 1997	20,549,273	$	5,038,936

b) Stock options:

The Company has the following stock options outstanding:

200,000 options to acquire shares at $0.10 per share expiring October 18, 1999

200,000 options to acquire shares at $0.30 per share expiring April 3, 2001

100,000 options to acquire shares at $0.30 per share expiring September 12, 2001

666,667 options to acquire shares at $0.30 per share expiring September 25, 1998

7. INCOME TAXES

Income tax expense differs from the amount which would be obtained by applying the basic combined Federal and Provincial tax rate to the respective years earnings (loss) before income taxes. These differences result from the following items:

		1997		1996
Expected income tax rate at 36.62%	$	790,393	$	(6,453)
Increase (decrease) resulting from:				
Reduction of income taxes through application of loss carry-forward		(217,093)		–
Unrecorded benefit of loss carry-forward		–		6,453
Other		7,973		–
	$	581,273	$	–

8. COMMITMENTS

The Company has entered into equipment leases which are considered operating leases for financial statement presentation purposes. The annual commitments are as follows:

1998	$ 116,415
1999	116,415
2000	112,752
2001	105,427
2002	35,142

9. SUBSEQUENT EVENTS

a) On July 29, 1997 the Company signed a letter of intent to acquire the proprietary rights and business in connection with the downhole motors and other tools of an oilfield supply company subject to regulatory authority and shareholder approval. The total consideration of the purchase is $4,600,000 plus a purchase price adjustment equal to 4% of all gross sales or rentals of products using the technology covered by the products for a period of 15 years following the date of the approval of the transaction by the shareholders. The Company proposed to provide the following consideration:

   i) 2,900,000 Class A shares at a price of $0.40 per share

   ii) 6,100,000 Preferred Class 1 shares at a price of $0.40 per share

   iii) $1,000,000 promissory note, without interest, due 15 years after the approval of the transaction by the shareholders.

b) In conjunction with the approval of this acquisition of the rights and business outlined above, the Company will apply for an amendment to the capital structure of the Company. This restructure will include the redesignation of the Class A shares as common shares, the creation of Preferred shares and the removal of Class B, Class C, Class D and Class E shares.

CORPORATE INFORMATION

Directors and Officers

William Wenzel
Director
President and
Chief Executive Officer
Master Downhole Tools Inc.

Donald Barber
Director
Secretary Treasurer and
Chief Financial Officer
Master Downhole Tools Inc.

Hon. Harvie Andre
Director
Managing Director of Canop Worldwide

Peter Lylick
Director
Secretary Treasurer of Superior Rentals Ltd.
Director of Hyduke Resource Capital Inc.

R Greg Powers
Director
Partner
Donahue Powers

Corporate Offices

Suite 1405
505 - 6th Street S.W.
Calgary, Alberta
T2P 1X5
Phone: 403-205-6696
Fax: 403-265-8154

Manufacturing Facilities

5905 - 86 Street
Edmonton, Alberta
T6E 2X4
Phone: 403-440-4220
Fax: 403-469-8054

Bankers

Bank of Montreal
Edmonton, Alberta

Registrar and Transfer Agent

Montreal Trust
Calgary, Alberta

Auditors

Doane Raymond
Calgary, Alberta

Solicitors

Donahue Powers
Calgary, Alberta

Master Downhole Canada Inc.

Manufacturing Facilities
5905 – 86 Street
Edmonton, Alberta
Canada T6E 2X4
Phone (403) 440-4220
Fax (403) 469-8054

Corporate Offices
1405, 505 – 6 Street SW
Calgary, Alberta
Canada T2P 1X5
Phone (403) 262-3050
Fax (403) 265-8154

Branch
12308 FM 3083
Conroe, Texas
U.S.A. 77301
Phone (409) 441-1480
Fax (409) 756-5335

email
wenzel@planet.eon.net

url
http//www.downhole.com